Cash retention under construction contracts:

short life working group final report and recommendations

July 2021

Scottish Government
Riaghaltas na h-Alba
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1. Executive Summary

1. This report concludes the work of the short life working group established in January 2021 by the Minister for Business, Fair Work and Skills to consider and make recommendations on the practice of cash retentions under construction contracts.

2. This summary sets out the recommendations which we believe will, if implemented, resolve many of the challenges associated with the use of retentions. The full report provides further detail on the work of the group, and of our recommendations.

3. The Short Life Working Group (SLWG) has maintained a clear focus on the remit it was set. Members consistently displayed their drive to deliver practical solutions and worked effectively together demonstrating collaboration, goodwill and creative thinking.

4. We recognise that our recommendations must be considered alongside other proposals for change within the construction sector and, in particular, the work of the Construction Leadership Forum (CLF) and the pathway to longer term industry transformation set out in the Construction Recovery Plan (Recovery Plan - Construction Forum Scotland and Construction Accord (A Scottish Construction Accord is in development)

5. Following detailed discussions, we are clear that our ambition is to see a significant reduction in the use of retentions in construction contracts, with alternative mechanisms in place to ensure high quality delivery and contract compliance. This aligns with the Scottish Government's long-term aspiration to reduce or remove the need for retentions, with alternative mechanisms in place to ensure contract delivery and compliance (reflected in the work of the Construction Leadership Forum Recovery Plan (above) to improve construction quality, including regulatory compliance). This position is also supported by key stakeholders such as Build UK and the Civil Engineering Contractors Authority (CECA), among others.

6. We are also clear that we do not, at this time, support an outright ban on the use of cash retentions in construction contracts in Scotland. This is because there is no straightforward, low cost and easily accessible alternative mechanism of assurance available to all of the industry. Organisations which commission construction work must have the ability to avoid becoming liable for unmet contract performance by implementing means of assuring it. We believe that a near term ban on retentions would create a significant shock within the sector at a time when it is already facing many challenges.

7. The SLWG unanimously supports the following actions which are described in more detail in the body of the report. We believe they will deliver tangible outputs to improve cash-flow and business sustainability across the construction sector, particularly for SMEs, who are often disproportionately affected by the current practice of retention.

8. Members of the SLWG are keen to see these recommendations implemented as quickly as possible with some members eager to see legislation in this area as a priority. However, the group recognise that wider consultation and business case development will be necessary before legislation can be brought before the Scottish Parliament.

9. Although the work of the SLWG is now complete members expect to be advised of progress and have offered to act as a sounding board as recommendations are developed and implemented.

10. Our recommendations are as follows;

   - Scottish Ministers should take forward legislation that will apply to both public and private sector construction contracts to establish a statutory custodial Retention Deposit Scheme, following development of a detailed business case

   - Scottish Government should publish a retention best practice policy note for contracting organisations by end January 2022 and consider with contractors, professional bodies and the wider industry, how best to disseminate and promote compliance. This should include a move towards automatic release of retentions at the earliest opportunity unless a clear issue had been identified and an approach to, and timetable for, resolution set out. It will also provide a requirement that organisations withholding a cash retention should not:

     - repay late or partially, without full and clearly articulated justification
     - render it liable to claim by an upstream insolvent supply chain party
     - use more than one form of assurance on construction contracts

   - by end January 2022 the Scottish Government should invite all contracting authorities involved with major construction projects (a major construction contract is defined in the Scottish Public Finance Manual as one which “has a total anticipated whole life cost of £5m+) to publish their retention policy and monitor and report on compliance. This should be a requirement for all major projects delivered using Scottish Government finance

   - within six months of project handover (practical completion) for each major construction contract, require contracting authorities to publish their compliance with retention best practice or explain how and why they have deviated from it

   - Scottish Government should ensure that reference to retentions and fair payment is included within the Construction Accord

   - Scottish Government to work with industry to ensure retention best practice is reflected in standard construction contracts, including dispute resolution and conflict avoidance procedures and agreed payment procedures

- promote further consideration/implementation across the sector of the removal of retentions from contracts as demonstrated by Network Rail. This includes;

    - progress payments not subject to automatic deduction as work proceeds
    - the final payment adjusted to place greater emphasis on completing project closure activities such as the Health and Safety file and producing a [priced] list of patent defects

- upon publication of best practice policy notes, Scottish Government and industry should host a major conference or series of webinars to focus on the promotion and implementation of retention best practice, including conflict avoidance

- invite Government Enterprise Agencies to work with representative bodies and businesses in the construction sector to identify and deliver efficiency opportunities. This might include a feasibility study to consider implementing an approach to the management of construction project cash-flow using digital technologies such as smart contracts

11. Members of the Short life working Group:

    - Oonagh Gil - Chair
    - Ann Allen - CICES (Chartered Institute of Civil Engineering Surveyors)
    - Lynda Campbell - I H Brown
    - Colin Baird - Balfour Beatty
    - David Christie - Robert Gordon University
    - Mike Conroy - UK Finance
    - Christina Gaiger - RIAS (Royal Incorporation of Architects in Scotland)
    - Iain Gardiner - Colorado Group
    - Colin Judge - Scottish Government – Scottish Procurement and Property Directorate
    - Gordon Matheson - Matheson Plumbing
    - Paul McAloon – Robertson Group
    - Jim Rankin - Glasgow City Council

2. Background

12. The construction sector is a crucial part of Scotland's economy, accounting for £7.8 billion of Gross value Added (GVA) and annual turnover of £19.2 billion in 2018. The sector also provided employment to 143,000 people in 2019. There were over 47,000 businesses operating in the sector in 2020 of which 99% of those were small enterprises (0-49 employees).

13. Following concerns expressed by parts of the industry on late and non-payment of retentions and the disproportionate effect on SMEs, the Scottish Government agreed to undertake a review. To support the review, the Scottish Government commissioned independent research from Pye Tait (Retentions in the Scottish Construction Industry Pye Tait report.pdf (consult.gov.scot)) and held a public consultation on their use in the construction sector in Scotland (https://consult.gov.scot/industrial-sectors/retention-payments-in-construction/)

14. There is evidence (Pye Tait) that the practice of retention does not work to the advantage of the Scottish construction sector. Cash retention, where the process is misused or abused is a barrier to investment, productivity improvements and growth. The Pye Tait report notes:

    > "The overall perception of the practice of retentions is negative. Many recognise the system's role in protecting clients and higher Tier contractors from potential for poor quality work and the subsequent need to rectify latent defects. However, many interviewees feel that the system is poorly administered by all parties and open to abuse."

15. The impact of this is significant and in a sector with small profit margins. The time and energy lost in tracking and chasing retentions payments and the disproportionate impact this has on SMEs undermines a sector of great importance to the Scottish economy.

16. A retention is money withheld from payment of a construction project. The part of the contract sum which is held back is intended to provide a means of incentivising contractors and subcontractors to return to correct any defects during a specified period of time or to provide a means of funding the procurement of another contractor to do so, if necessary, as outlined in contract terms and conditions. In most cases a retention is imposed by the client employing the main or Tier 1 contractor and this is mirrored in subsidiary contracts throughout the supply chain. In Scotland, as across the rest of the UK, the retention amount is typically 5% of the contract value, although often 3% in projects worth over £5 million. The defects liability (maintenance) period is typically 12 months after practical completion, although it is often programmed to extend beyond this period depending on project type and complexity or for other reasons (Pye Tait). The group heard of examples of retentions being held for 5 or more years, and of the challenges SMEs often face in recovering these payments.

17. For the purposes of its work, the SLWG agreed the following definition of retentions:

> Retentions represent an amount deducted and withheld from each progress payment made to a contractor or subcontractor to secure obligations under a construction contract and ensure defects are remediated without the holder becoming liable for costs arising from unmet contract performance.

18. The retention system is a long-standing practice in the construction industry throughout the UK and the Scottish Government consultation found that there are a range of views across Scotland's construction sector about the current use of retentions and on the best way of assuring construction contracts.

19. Several key issues were identified through the research and consultation process:

    - evidence suggests that retentions can distort the market, with a significant proportion of companies saying they deliberately avoid business in which retentions are involved
    - the current system of retention operates to the advantage of clients and Tier 1 contractors but to the disadvantage of medium and smaller companies, particularly where a contractor insolvency might occur
    - qualitative evidence suggests that late and non-payment of retention monies is a significant issue for some contractors
    - medium and smaller businesses believe that the practice of retentions in its current form inhibits their business growth, causes a drag on cash-flow, weakens relationships, and reduces investment

20. This document sets out the recommendations of the SLWG established to consider the options that emerged from the consultation process. These were:

    - legislate to ban retentions
    - introduce a retention deposit scheme
    - recommend an alternative mechanism of assurance

21. Our approach to this work was to consider each of the three options in turn whilst recognising that organisations which commission construction work must have the ability to avoid becoming liable for costs arising from unmet contract performance by implementing a means of assuring it.

22. We are clear that whilst some of the alternative mechanisms discussed provide assurance on construction projects or provide security of payments, none appear to provide an appropriate stand-alone solution to all of the issues associated with the practice of cash retention.

23. Having considered options, including a ban on retentions, the SLWG strongly support the development and implementation of a custodial retention deposit scheme in Scotland. Further work is necessary to set out the details of such a scheme, including how best to secure automated payments and align with, for

example, HMRC requirements. The group believe such a scheme would resolve many of the problems currently associated with retentions.

24. The SLWG recognise that it will take some time for a statutory scheme to be established, and have made a number of further recommendations to improve the current system including providing the industry with much needed best practice guidance to help negate some of the bad practice that has developed.

3. Methodology

25. The Short Life Working Group (SLWG) were asked to investigate a fairer, more neutral and more protected approach to assurance in construction contracts and propose a practical methodology to Scottish Ministers.

26. We were provided with a baseline for discussion as follows:

    Baseline: Organisations which commission construction work must have the ability to avoid becoming liable for costs arising from unmet contract performance by implementing a means of assuring it.

    As a minimum, the SLWG were asked to consider the options that emerged from the Scottish Government consultation:

    - legislate to ban retentions
    - introduce a retention deposit scheme
    - consider the merits of alternative mechanisms of assurance

27. We were asked to:

    - consider the information from the Pye Tait report on the practice of cash retention under construction contracts
    - investigate the options and compile a strong evidence base including, where possible, providing full costings
    - propose a practical preferred option to Scottish Ministers for implementation pending any necessary further detailed consideration

28. Membership of the SLWG was drawn from across the sector to represent the breadth of views on the practice of retention, and the possible solutions to address the issues associated with their use.

29. The group met on six occasions: an introductory session, three meetings to cover each of the proposed options and two meetings to consider and agree recommendations.

4. Key Findings

30. We considered three options identified through the consultation exercise and our key findings were as follows:

Option 1 – Legislate to ban retentions

31. In considering the option of an outright ban on retentions, we recognised that this could deliver some benefits. In particular:

- retention abuses would be removed, and the payee (‘payee’ – the entity from whom retention is withheld (opposite of ‘payer’ – the withholding entity)) could avoid loss of retention money through upstream insolvency
- cash otherwise held in retentions would be unlocked and available for more productive use
- removal could drive development and expansion of the assurance market, and deliver better collaboration
- it may facilitate technological innovation such as the use of, for example, smart contracts (a smart contract is a computer program or a transaction protocol which is intended to automatically execute, control or document legally relevant events and actions according to the terms of a contract or an agreement), especially where operating alongside other technologies, such as Building Information Modelling (BIM). This could provide more efficient and secure payment mechanisms
- a ban may be consistent with, and could precipitate, the shift towards offsite manufacturing technologies and a better quality of product

32. The SLWG also recognised that a ban on retentions would be likely to raise issues of concern, in particular:

- in the absence of new and low-cost assurance products there would be a disproportionate impact on Small and Medium Enterprises (SMEs): a large proportion of contractors may not be able to get affordable alternatives
- new solutions could also be more burdensome on SMEs, reflecting the imbalance in commercial bargaining power
- the group were not confident that the assurance market would provide alternative insurance products to all clients and construction firms. It concluded that using alternative assurance products would be likely to introduce additional costs with no certainty that these would be outweighed by the losses avoided due to upstream insolvency
- an outright ban would be an unwelcome shock to the construction industry in the short and medium term
- the SLWG were concerned that a legislative ban could be circumvented by commercially driven practices. It may not stop all abuse and could trigger new forms of payment practice abuse that would be difficult to monitor

- costs of any alternative products/approach would need to be passed on or absorbed leading to a possible increase in construction costs
- it is not clear that costs of assurance would be offset by savings from monies currently lost by contractors through the use of retentions. This is likely to be a significant issue for many contractors who operate with small margins
- the variety and range of stakeholders within the construction industry and the variety of projects which they service means that a “one size fits all” approach will be difficult

33. The group considered all of these issues in full and concluded that we do not support an outright ban on cash retentions in the short or medium term.

Option 2 – Introduce Retention Deposit Scheme

34. We considered Retention Deposit Schemes which can be either custodial or insurance backed**. A custodial scheme** would hold retention money as cash deposited into an account set up solely and exclusively for that purpose, and which is neither designed nor intended for the money to be used as working capital by the account holder(s). **An insurance based scheme** would allow the retention to be held in the bank account of the payer. Retention money is deducted from payments and held by the payer, who holds a protection policy from an independent scheme for the period of the construction contract.

35. We received an informative presentation from Mike Bell and Chris Van Halewyn, who have designed the Retention Deposit Clearing House, an insurance based scheme which they intend to pilot. This scheme proposes a national statutory system utilising insurance to create a low-cost scheme to protect retention monies for the benefit of contractors (including subcontractors) in the construction industry.

36. The SLWG agreed that this was an interesting proposal although members of the group expressed concern about the impact and uncertainty of additional costs to the sector, particularly for insurance, and especially in the current economic climate. We heard that the scheme would bring an additional cost to industry estimated to be around £23 per £10,000 of contract value. Group members expressed some concern about delivery at that price and whether the insurance market would have the appetite for such a scheme. Similar concerns were raised through discussions with financial sector stakeholders (representatives of major banks, UK Finance). This scheme proposes a statutory scheme with a single provider, and members of the group had some misgivings about delivery through a single private sector provider.

37. We also heard about Tenancy Deposits Schemes (TDS) that support the private rented sector housing market in Scotland. These are custodial schemes that hold and protect private renters’ deposits until they are due to be repaid. These custodial schemes have operated effectively since being introduced in 2011. The schemes include a dispute resolution service and are

funded through interest earned on the funds. There is no additional cost to either landlord or tenant.

38. In April 2021, 234,064 deposits were being protected in the schemes with £165.8 million held in designated accounts.

39. We believe the TDS provides a good model of a custodial deposit scheme and, although there are many differences between construction retentions and tenant deposits, we believe the TDS provides a strong example of a custodial scheme which operates efficiently and effectively for all parties. The group favour a custodial over an insurance backed retention deposit scheme.

40. We believe there would be several benefits of introducing and utilising a Retention Deposit Scheme (RDS). Most notably:

    - the money is protected, ensuring it is available and not affected by insolvency
    - it should lead to greater transparency between payer and payee
    - automatic release of payment would reduce incidences of “late” and “non-payment”, and reduce payees’ time needed to chase retention payments
    - this would be likely to lead to a positive change in industry culture with more careful consideration of the use of retentions. In particular there would be no cash-flow incentive to clients or Tier 1 contractors
    - although an RDS would not remove the use of retention, we expect it would reduce their use and provide security for deposits, greater certainty of cash-flow and so support business investment and confidence, particularly for SMEs

41. We concluded that:

    - an effective retention deposit scheme could resolve many of the problems associated with retentions
    - there is currently no operational deposit scheme which could be adopted for retentions, and therefore limited evidence is available to assess how this would work in practice. Consequently, we are not able to clearly assess the costs or determine the detailed nature of an RDS for Scotland. Further work will be required to shape and develop a business case
    - an effective RDS must:
        - include a payment release mechanism
        - provide rapid dispute resolution
        - be straightforward, easy to access and low cost
    - the detail of any scheme must be carefully considered including clarifying role, scope and number of gatekeepers (Gatekeeper – responsible operator for overseeing funds)
    - the tenancy deposit scheme, which is free to use, may provide the basis of a RDS model – further exploration is required

42. Part of the SLWG's remit was to provide (where possible) full costings associated with the recommendation considered but this has not been possible in the relatively short timescale that the group had to consider options. Costings should be properly considered through development of a detailed Business Case which should also consider legislative options for delivery.

Option 3 – Recommend an alternative mechanism of assurance

43. The SLWG considered six alternatives identified through Pye Tait research as follows:

- Performance bonds
- Retention bonds
- Escrow stakeholder accounts
- Parent company guarantees
- Project Bank Accounts (PBAs)
- Retentions in Trust

44. The SLWG agreed that whilst some of the alternative mechanisms discussed provide assurance on construction projects or provide security of payments, none appear to provide an appropriate stand-alone solution to the issues associated with the practice of cash retention. We agreed that:

- a "one size fits all" approach is not appropriate as an alternative to cash retentions and in any case none of the above mechanisms would deliver it
- although performance bonds appear to be suitable for use across the industry and are the most commonly used alternative mechanism of assurance, they are unlikely to be available to all in the sector
- the cost of alternatives, particularly bonds, are likely to be prohibitive
- other mechanisms of assurance are mostly used in addition to cash retention rather than as an alternative
- the alternatives to cash retention are already known and available to the industry. They appear to be rarely used in place of retentions
- retentions placed in trust protect them from the risk of insolvency but issues around the obligations of trustees appear to be prohibitive and need to be considered in more detail
- there was doubt about the appetite for the financial sector to provide suitable financial products that were affordable and accessible to all

Further discussion

45. Members of the group discussed their experience of good and bad practice in relation to retentions. Our discussion highlighted that the use of retentions has evolved over many years and there are no set guidelines on how the construction sector currently use retentions as a form of assurance. Group members highlighted many instances where, in addition to retentions, other forms of assurance were used to provide an additional layer of protection for clients/contractors. They spoke of the frequent challenge of securing payment of retention monies, including spurious claims of defects leading to refusal of payment and lengthy processes to secure monies owed. There is concern that adjudication of disputes has become expensive and time consuming. Some contractors and specialist organisations are choosing not to take on work where retentions are proposed. The current practice of retentions often negatively impacts business relationships whereas there is evidence that better relationships can be developed through a "no retention" approach as demonstrated by Network Rail.

46. Network Rail approach: Cash retentions are no longer used between Network Rail and its Tier 1 Capital Works suppliers, formalising the approach of the Network Rail Fair Payment Charter. Network Rail's standard terms and conditions for Control Period 6, which runs from 1 April 2019 to 2024, also prohibit the use of retentions between Tier 1 Capital Works contractors and their Tier 2 sub-contractors.

47. The Charter was drafted by the Commercial Directors Forum (CDF) established by Network Rail to promote, support and influence commercial policy in the rail industry. CDF members agreed to apply the principles of the Charter in delivering rail capital works, including:

    - any withholding of payment due to defects, non-delivery or the absence of proof will be proportionate and demonstrably justified
    - client arrangements for retention will be replicated via matching terms throughout the supply chain where practicable

48. The no retentions policy was part of a range of options on alternatives to retention proposed by Network Rail's suppliers and has been implemented in consultation, co-operation and collaboration with them. In order to ensure that work meets agreed standards Network Rail puts in place a cost-loaded programme and cash flow forecast for projects, including monetary amounts allocated to final delivery and project closure activities covering matters such as:

    - complete and timely production of a comprehensive Health and Safety File
    - compliant supply and/or fixing of final-stage and project-critical construction components

49. We heard that this approach works well, providing more clarity for businesses and building better working relationships between partners. We recognise that Network Rail has a relatively small (specialist) group of contractors from whom they procure their work, and this facilitates the ‘no retentions’ approach which has been adopted. Although it may be difficult to transpose this approach to all construction contracts we believe there is scope for this model to be deployed more widely, particularly in areas of specialist construction and where framework agreements are in place.

50. We do recognise that for some the current system of retentions seems to work well, particularly clients and Tier 1 contractors delivering large developments where there is less risk of insolvency. However, the problems that can arise are most acutely felt by SMEs for whom monitoring, chasing and securing payment of retentions often brings a disproportionate cost and a heavy impact on cash flow. Pye Tait highlighted that ‘Qualitative evidence overwhelmingly shows that the biggest problem with the practice of retentions is the instability it creates for contractors at Tier 2 and below’. In addition, research documents that many believe retentions damage working relationships by creating an adversarial working relationship and encourage friction and disputes. This may not always be visible to clients and main contractors. We recommend further discussion with client groups, professionals (surveyors/architects etc) and the wider industry to ensure our recommendations are fully understood and the reason for each is recognised.

5. Recommendations

51. Our ambition is to see a significant reduction in the use of retentions in construction contracts, however we recognise the urgent need to improve current practice and deliver a fairer, and more neutral and protected approach to retentions. Our recommendations seek to deliver tangible improvements to retention practice. Our recommendations have been agreed by all members of the working group and are as follows:

- **Scottish Ministers should take forward legislation that will apply to both public and private sector contracts to establish a statutory custodial Retention Deposit Scheme following development of a detailed business case**

  Context:

  Having considered all three headline options within our remit (outright ban, RDS or an alternative form of assurance) we have unanimously agreed that this option presents the best course of action to address the issues often associated with retentions and identified in earlier research. We favour a custodial model which holds retentions payments in an independently run, protected deposit scheme for the period of the construction contract and delivers automatic payment.

- **Scottish Government should publish a retention best practice policy note for contracting organisations by end January 2022 and consider, with contractors, professional bodies and the wider industry, how best to disseminate and promote compliance. This should include a move towards automatic release of retentions at the earliest opportunity unless a clear issue had been identified and an approach to, and timetable for, resolution set out. It will also provide a requirement that organisations withholding a cash retention should not;**

  - **repay late or partially, without full and clearly articulated justification**
  - **render it liable to claim by an upstream insolvent supply chain party**
  - **use more than one form of assurance on construction contracts**

  Context:

  We are very keen to have best practice guidance developed and disseminated in a way that is accessible to all contractors. This must negate bad practice. In order to ensure this is easily understood and adopted by all, the Scottish Government should take forward this work with clients, contractors and key professionals. This should result in clearly documented retention payment procedures and agreed best practice. In addition to the points raised above we believe this should also consider:

- staged payments which are linked to the completion of the particular work (i.e. a retention held against a company completing groundworks at the start of a project should not be held until the entire project has been completed)
- the need to hold only the value of retention that reflects defects outstanding
- a requirement that cash retentions should only be held for the minimum time necessary to achieve assurance of completion of the works
- no retention held on temporary works such as scaffolding which will not form part of the permanent works
- how and why retentions are released
- how we ensure compliance with the guidance

- **By end January 2022 the Scottish Government should invite all contracting authorities involved with major construction projects (para 10) to publish their retention policy and monitor and report on compliance. This should be a requirement for all major projects delivered with Scottish Government finance**

  Context:

  We believe it is important for contracting authorities to consider and clearly set out their policy on the use of retentions in construction contracts. This recommendation is intended to provide some welcome visibility and accountability on how contracting authorities approach and use cash retentions. We consider this an important step to clarify and potentially standardise the use of retentions by contracting authorities. Guidance on publication and an example that adopts the best practice guidance could be set out in the best practice policy note referenced in recommendation 2.

- **Within six months of project handover (practical completion) for each major construction contract, require contracting authorities to publish their compliance with retention best practice or explain how and why they have deviated from it**

  Context:

  This recommendation builds on recommendation number 3 and is intended to provide visibility of the approach to and practice of retention use for each major construction project. This will help to deliver accountability and highlight where best practice is applied. Scottish Government should identify where contractor's retention policy and their compliance with this is published, ensuring this is easily accessible to a wide audience. We recognise that the timeframe for reporting is likely to be before the end of the defects liability period (normally 12 months) but we do not believe this should deter early reporting of compliance with best practice.

- **Scottish Government should ensure that reference to retentions and fair payment is included within the Construction Accord**

Context:

We recognise that the construction sector in Scotland is undergoing significant change and modernisation. The work of this group must be considered in the context of the transformation agenda and complement the wider work that is already being undertaken. The Scottish Construction Accord, currently in development, aims to establish a dynamic collaboration and platform for the whole of the construction industry to work together more effectively to:

- meet the infrastructure delivery challenges we face as a country
- enhance the industry's positive contribution to Scotland's economy, society and environment
- deliver the change and action necessary to achieve these aims and ambition

We believe retention best practice should be recognised in that document.

- **Scottish Government to work with industry to ensure retention best practice is reflected in standard construction contracts, including dispute resolution and conflict avoidance procedures and agreed payment procedures**

  Context:

  The construction sector regularly utilises a suite of standard contracts available from organisations such as the Scottish Building Contracts Committee (SBCC). As the pan industry organisation that produces building contracts designed to meet the needs of the construction industry in Scotland SBCC produce contracts compliant with Scottish law and practice. The SLWG believe there is scope to have some of the standard clauses within these contracts reflect retentions best practice guidance and we should seek to explore that.

- **Promote further consideration/implementation across the sector of the removal of retentions from contracts as demonstrated by Network Rail. This includes:**

  - **progress payments not subject to automatic deduction as work proceeds**
  - **the final payment adjusted to place greater emphasis on completing project closure activities such as the Health and Safety file and producing a [priced] list of patent defects**

  Context:

  The SLWG heard evidence about the Network Rail "No Retention" policy and believe this model works well. The group felt that, while not suitable for all areas of construction, this approach could be more widely used. Explaining and promoting this model more widely with industry could form part of the commitment to engage with the sector at recommendation 8.

- **Upon publication of best practice policy notes, Scottish Government and industry should host a major conference or series of webinars to focus on the promotion and implementation of retention best practice, including conflict avoidance**

  Context:

  It is considered that this will be an important part of changing industry culture around retentions.

- **Invite Government Enterprise Agencies to work with representative bodies and businesses in the construction sector to identify and deliver efficiency opportunities. This might include a feasibility study to consider implementing an approach to the management of construction project cash-flow using digital technologies such as smart contracts**

  Context:

  We heard evidence of the fast pace of change and opportunities for the development of improved systems to deliver efficiencies realised, for example, through the use of smart contracts (para 32) and from new digital technologies. These could potentially be applied in the construction sector and support work to improve the practice of retention payments. The group were keen that the Scottish Government and its enterprise agencies, led by Scottish Enterprise, possibly working with CivTech, consider the advantages of new and innovative digital technologies and work with Business Gateway and the industry to promote and roll out products that can deliver efficiencies across the construction business base.

6. Retention Deposit Scheme – Development of Business Case

52. The Short Life Working Group consider that where retentions continue to be used in construction projects the money should be held in an independent Retention Deposit Schemes (RDS). An RDS can be either custodial or insurance. The short life working group considered both types of scheme and had reservations about an insurance backed scheme in the current economic climate. It is clear that Insurers consider much of the construction sector to be high risk and so an insurance backed RDS is potentially a costly proposition and subject to the volatility of the insurance market. With the industry already seeing sharp rises in premiums in relation to Professional Indemnity Insurance the group consider that a custodial scheme can deliver more certainty for businesses.

53. This section of the paper considers a custodial scheme which would hold retention money as cash deposited into a ring-fenced account set up solely and exclusively for that purpose, and which is neither designed nor intended for the money to be used as working capital by the account holder(s). It sets out areas to be considered further in the development of a detailed business case and before legislation is enacted. The business case should also consider whether it is possible to pilot such a scheme in advance of parliamentary consideration, utilising the weight of public sector construction contracts. The main principles of such a scheme include:

- retention money deducted by the payer is transferred and held in an independently run, protected deposit scheme for the period of the construction contract or as agreed between parties
- payer is responsible for registering the retention and transferring it into a deposit scheme in order for it to be protected.
- automatic release of retention on sub-contract PC (Project Completion) and DLP (Defects Liability Period). This removes “pay when paid” (jargon for the construction sector commercial practice of payers making their obligation to a payee in one contract dependent on being paid firstly in another contract. Banned by the Housing Grants, Construction and Regeneration Act 1996 but still prevalent) and allows parties to focus wholly on assessing whether there are issues with the work such that intervention is necessary to prevent automatic release of the monies
- defined processes prior to automatic release date – Payer to review works for possible defects prior to release date, clearly articulating issues and what needs to be rectified, with opportunity for payee to respond. This allows payee opportunity to address any defects
- if an unresolved dispute emerges this is referred to an appropriate and proportionate dispute resolution process and the retention is held by scheme pending decision
- otherwise retention is released automatically, unless evidence justifying otherwise is submitted, with the relevant notice period and production duration written into the construction contract

- Specified Release procedures are established in the event of either an upstream or downstream insolvency

Retention Deposit Scheme

Topic	Areas to Consider
Business Need	£124 million in cash retention is thought to be held under construction contracts in Scotland at any one time (Pye Tait) There is evidence that late and non-payment of retentions is a significant issue for businesses in Scotland. This falls disproportionately on SMEs Some businesses will not tender for work where a retention is to be held again them
Organisational Overview	The Scottish Government believes in fair, transparent and prompt payment practices and recognises the importance of a thriving construction sector
Contribution to Key Objectives	Provides assurance against upstream insolvencies and retention abuse Provides assurance against underperformance Removes cash flow incentives from retentions Provides greater confidence across the sector but particularly to SMEs
Stakeholders	Engagement across the construction industry will be required. Those commissioning construction contracts, Professional bodies (RICS/RIAS), construction businesses etc

Existing Arrangements	Cash retention (typically around 5 per cent of contract value) in construction industry contracts is a long standing practice, particularly in the public sector. The retention (the 5% of contract value) is withheld from the party completing construction works (full payment is not made) to ensure they properly complete activities required of them under contract, particularly once they leave site. At practical completion on-site, half the retention is returned to the contractor. The remainder is retained for a period (defects liability period) determined by the contract (commonly 12 months) in order to insure against defects which arise after practical completion Ordinarily the retention is simply held in the bank account of the client/contactor imposing the retention and can be used for other purposes although it remains committed to pay for work completed.

Scope	The business case must, at a minimum: • determine how the scheme will align with existing legislation (such as tax, trusts, insolvency, money laundering etc) • determine payment release mechanisms, and alignment with construction contracts • ensure ease of access (who can access funds, how and when?) • include a mechanism for dispute resolution • include the design and delivery of a mechanism for easy payment and automatic release • consider staged payments linked to completion (i.e. a retention held against a company completing groundworks at the start of a project should not be held until the entire project has been completed) • consider costs of delivery and scope to be free to use, utilising interest on investments to fund operational delivery • benefits and disbenefits of provision through private, public, third and not for profit sector • consider opportunities to use smart banking technology to support the ambitions of the scheme
Constraints	Cost and complexity of any retention deposit scheme – At a minimum any scheme should be able to operate through the interest raised on funds deposited i.e. it should pay for itself and require no additional funding in line with schemes associated with tenancy deposits Payers may chose not to use cash retentions and this may affect the commercial viability of any scheme that is established Delivery of schemes may be insufficient – market appetite

7. Next Steps

Action	Delivery By
Establish Business Case and deliver a Retention Deposit Scheme – this is a key priority - early discussions with stakeholders should be undertaken to develop the scope for delivery and thereafter a tendering process to identify the most suitable organisations to develop a detailed Business Case. Should a suitable Business Case be established bring forward legislation to establish a statutory custodial retention deposit scheme	30.06.2022 31.12.2022
Develop Best Practice Guidance – working with industry, agree and record best practice guidelines and develop a best practice policy note including guidance for all contracting authorities to publish their retention policy and report and monitor compliance. Work with professional institutes including RICS/RIAS to help disseminate best practice guidance and appropriate training to ensure this is relayed to their members who are integral to the advice given to clients/contactors about assurance.	31.01.2022 31.01.2022
Ensure retentions best practice is included in Construction Accord – work with the Construction Accord leads and the Construction Leadership Forum to ensure retentions best practice is included within the final iteration of the Construction Accord (in development).	31.12.2021
Construction Contracts – work with industry (RICS, RIAS, construction lawyers, Clients etc) and the Scottish Building Contracts Committee (SBCC) to consider how retentions best practice can be better reflected within standard construction contracts.	31.01.2022
Promote best practice – Develop and host an industry conference/series of webinars which focus on the implementation of retention best practice including conflict avoidance.	31.03.2022
Wider Support – Invite Government Enterprise Agencies and Business Gateway, possibly alongside CivTech, to work with the construction industry to help businesses deliver efficiency opportunities. Scottish Enterprise should set out an action plan for this work and submit this to the Minister during the summer.	30.09.2021

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